Outlook and Policy

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INTERNATIONAL ECONOMIC OUTLOOK IN 2009

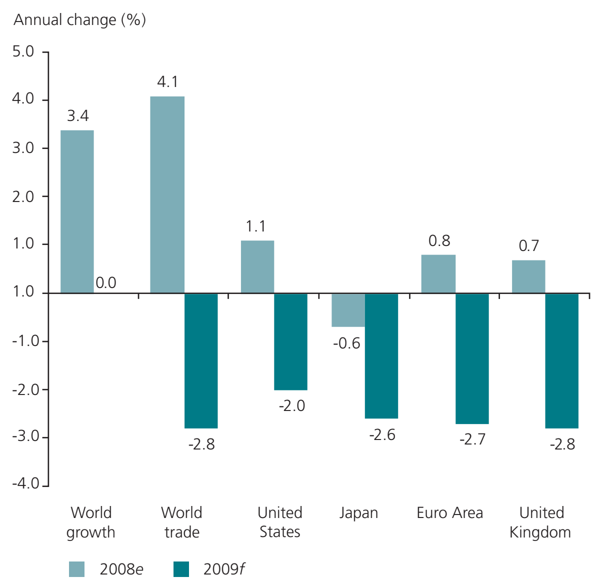
The global economy is not expected to record any growth in 2009, with a large number of economies experiencing a synchronised recession. Global financial markets will remain under stress in 2009 in spite of the extensive measures that have been unveiled, reflecting the ongoing need to repair and restructure the severely damaged balance sheets of a large number of systemically important financial institutions in several advanced economies. The weakened financial position of the financial sector in these economies is also expected to be further undermined as the deterioration in economic activities contributes to further writedowns and losses and dilution in the capital base of the financial institutions. The expected losses of US-originated credit assets held by banks and other financial institutions could increase to USD2.2 trillion[1]. Financial intermediation and confidence in the advanced economies are expected to take some time to normalise. Spreads in the funding markets are expected to remain elevated with lending standards remaining relatively tight. Market conditions in the international financial system will likely to remain challenging and are expected to stabilise when the announced policy measures are effectively implemented to restore confidence in the financial sector.

The global economy is not expected to record any growth in 2009 with a large number of economies experiencing a synchronised recession

The recession in the advanced economies is expected to be protracted. Alongside the continued impact of the credit crunch on domestic demand, private consumption will also face pressures from job losses and declining asset prices, while private investment will be constrained by the significantly weaker demand and higher unutilised capacity. These developments in the advanced economies will adversely affect the growth of the Asian regional economies given the contraction in trade and investment flows. The newly industrialised Asian economies (NIEs) as well as the ASEAN economies are expected to record anaemic to no growth, while PR China is expected to record sub-par growth due to the weaker exports and investment outlook.

In the **US**, the prospect is for further declines in real economic activity. Private consumption is expected to remain depressed in view of the persistent weaknesses in both the labour and housing markets. Since 2008, job losses in the US have increased to 4.4 million, while households have experienced wealth destruction of more than USD11.2 trillion due to the sharp declines in house and equity prices. This will require adjustments in household consumption which was significantly financed by accumulation of debt over several years, thereby accelerating the deleveraging trend that has taken place since 2008. In addition, the decline in investment is expected to be more broad-based, extending beyond residential

Chart 4.1
World Growth, World Trade and Growth in Major Advanced Economies (2008-2009)



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Source: International Monetary Fund and National Authorities

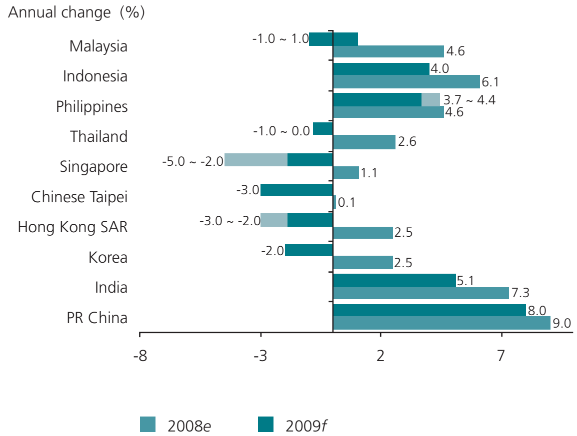
[1] IMF World Economic Outlook Update, January 2009

investment to non-residential investment following the depressed demand outlook, falling industrial production and rising inventory levels. The aggressive monetary and quantitative easing together with the USD787 billion fiscal stimulus package are, however, expected to provide support to the economy. A key policy priority is the successful implementation of the measures to resolve the financial sector problems, which is necessary to support the resumption in growth of economic activity.

The recession in the **euro area** is expected to deepen due to a combination of the housing slump in several economies such as Spain, Ireland, Denmark and Netherlands, as well as the impact of the financial turmoil in the region. The largest euro area economy, Germany, is undergoing an export-led recession, leading to a sharp fall in intra-regional trade that would also have an impact on domestic demand in the other euro area economies. The credit crunch in Europe is also expected to intensify due to the exposure of the Western European banks to the Central and Eastern European economies, which are affected by the current international financial turmoil. Meanwhile, in the **UK**, there are further signs of a deepening contraction in the economy due to the persistent credit crunch amidst the housing recession. **Japan**, being a more export-dependent economy, is expected to face further deterioration in its export sector and investment activities, which will prolong the recession that started in the second half of 2008.

With the advanced economies expected to experience a prolonged recession, **global trade** is expected to contract further during the year. This contraction is expected to have repercussions on the emerging economies with greater trade openness. The decline in global trade will also be accompanied by a decline in global foreign direct investment, as multinational companies scale down their investments amidst increasing capacity while global financial institutions cut back on financing.
As a region that is highly integrated with the global economy, the **Asian economies** will experience significant downside risks to growth in 2009. This will arise from the sharp contraction in external demand, low commodity prices and reduction in FDI inflows. These influences will, in turn, affect domestic private sector demand. Indicators show that domestic

Chart 4.2
Regional Economies: Real GDP Growth



e Estimate
f Forecast
Source: International Monetary Fund and National Authorities

demand has begun to moderate sharply since late 2008 due to weaker private sector sentiments, rising unemployment and large declines in production. The NIEs are anticipated to remain in recession in 2009, while the other regional economies are expected to face a sharp moderation in growth in 2009. The countercyclical fiscal measures that have been introduced by most economies in the region would also provide some support to growth in 2009. PR China is expected to register a lower growth, with support to growth coming from the implementation of the large fiscal stimulus of 13% of GDP over a two-year period.

Global inflation is expected to decelerate further in 2009 due to sluggish real economic activity and the sharp declines in commodity prices. Oil prices are expected to remain subdued as the decline in global demand is likely to outweigh the cuts in production initiated by the Organisation of Petroleum Exporting Countries (OPEC). Similar trends are expected to be observed in other commodities, including agriculture and base metals, reflecting the broad-based decline in global demand. The reversal of the trend in commodity prices and the significantly weaker demand conditions is expected to exert large deflationary pressures on headline inflation in most economies, with the possibility of deflation surfacing in some economies. Headline inflation in advanced economies is expected to decline to a record low of 0.3% in 2009. Meanwhile, inflation in emerging and developing economies is expected to moderate to 5.8% in 2009 from 9.2% in 2008[2]. Against this backdrop, monetary policy actions are expected to remain expansionary with additional quantitative easing in some cases, to address sector-specific issues in the financial markets.

Several **downside risks** remain on the global and regional outlook. The recession in the advanced economies could be prolonged by longer-than-expected structural adjustments in the household sector, particularly in the US, as households increase savings and reduce their overleveraged position. The financial sector resolution could also take longer than expected to be implemented effectively. In addition, support for the economy depends critically on the effectiveness of fiscal spending. The effectiveness of a combination of fiscal and monetary policy responses and large-scale global coordination in restoring the functioning of the financial system and markets are critical factors in determining the timing of economic stability in the respective economies. While the risks to the growth outlook in the advanced economies would have significant implications on the Asian regional economies, the region as a whole entered the current downturn from a position of strength, in terms of strong fundamentals and sound macroeconomic policies. This would, therefore, allow for greater policy flexibility in managing these downside risks. Moreover, the countercyclical measures that are being undertaken will also provide support to the real economy during this period of uncertainty.

MALAYSIAN ECONOMY IN 2009

Global economic and financial conditions, which deteriorated sharply in the fourth quarter of 2008, are expected to weaken further in 2009. Being a highly open economy, Malaysia has already been impacted by the adverse global environment with exports and industrial production declining, in particular, steeply since December 2008. The rapid deterioration in external demand also dampened private investment and consumption and has led to weaker labour market conditions, which contributed to the significant moderation in domestic demand in the fourth quarter of 2008. The Malaysian economy is expected to experience the full impact of the global downturn in 2009.

Taking into account the prospect for a deepening global downturn and the support to the economy provided by the policy measures, real GDP performance in 2009 is projected to be between -1% to 1%

In response, several policy measures have been put in place with a primary focus on supporting domestic demand, as well as mitigating the impact of the global slowdown on the affected segments of the economy. On 4 November 2008, the Government announced the first economic stimulus package amounting to RM7 billion. The funds would be allocated to projects which have a high and immediate multiplier impact on the economy. In addition, several measures to directly support private consumption were also introduced, such as a reduction of EPF contributions from 11% to 8% and higher vehicle loan eligibility for civil servants. As the global economic conditions deteriorated further in the fourth quarter of 2008 and in the early part of 2009, a second economic stimulus package of RM60 billion or almost 9% of GDP was announced on 10 March 2009. The package will be implemented over 2009 and 2010, and will involve spending on training, job creation, improving public infrastructure, school facilities and basic amenities, as well as establishing guarantee facilities.

Meanwhile, with the risk of inflation receding rapidly, the easing of the monetary policy has been front-loaded and directed towards supporting domestic economic activity by reducing the cost of intermediation. Bank Negara Malaysia has reduced the Overnight Policy Rate (OPR) by 150 basis points since November 2008 to 2.0%, while the Statutory Reserve Requirement

[2] IMF World Economic Outlook Update, January 2009

(SRR) has been reduced by 300 basis points to 1.0%. In addition, several measures have also been introduced to ensure continued access to credit as well as to minimise the impact of the economic downturn on specific affected groups. These include the setting up of four new financing facilities to facilitate access to financing by the small and medium enterprises and micro enterprises as well as measures by the financial institutions to lessen the burden on the affected groups through loan restructuring. Under the second economic stimulus package, two loan guarantee facilities, namely the Working Capital Guarantee Scheme and Industry Restructuring Loan Guarantee Scheme were established, to provide working capital and to encourage investment by businesses respectively. In addition, the Financial Guarantee Institution will also be established to provide credit enhancement to companies that raise funds from the bond market.

Taking into account the expectation of a deepening global downturn as well as the support provided by the policy measures, real GDP performance in 2009 is projected to be between -1% to 1%. Domestic demand is expected to provide the main support to the economy and is projected to record a positive growth, with public sector expenditure and private consumption as the main anchors. Public sector expenditure is projected to increase substantially following the implementation of the Government's stimulus measures, thus providing major support to the overall economic growth in 2009. The policy responses will provide important support to household consumption given the anticipated weakness in the labour market and relatively lower commodity prices. Private investment is expected to slow in an environment of a more broad-based slowing of economic growth.

On the supply side, sectors that are directly exposed to the external demand will be significantly affected in 2009. Output in the manufacturing sector is expected to decline due to the contraction in the export-oriented industries as well as weaker support from the domestic-oriented industries. The services sector is expected to still contribute positively to growth with continued expansion, albeit moderately, given the weaker performance in the trade-related industries. The agriculture and mining sectors will register negative growth due mainly to lower production of palm oil, rubber, and crude oil, in part discouraged by lower prices. Meanwhile, the construction sector is expected to record a stronger growth, benefiting from the implementation of projects under the two economic stimulus packages.

Labour market conditions are expected to weaken further, with the unemployment rate projected to increase to 4.5% in 2009. Businesses that are affected by the sharp deterioration in external demand are likely to continue to implement cost-cutting measures, including temporary layoffs and retrenchments. While employment in the public sector is expected to increase in 2009, this will not be able to fully offset the weak employment prospects in the private sector.

Headline inflation is expected to average between 1.5 – 2% in 2009. This reflects the sharp reversal of global commodity prices from their peaks in 2008 and slowing global inflation. The impact of downward adjustments to administered prices by the Government and the expected slowdown of domestic economic activity will also dampen price pressures.

On the external front, the current account surplus is projected to moderate, but remain sizeable at 11.5% of GNI in 2009. Although gross exports are expected to contract substantially due to the significant weakness in external demand and lower commodity prices, the trade surplus will remain sizeable as export contraction will largely be offset by import compression. The services account is expected to record a deficit in 2009 due to the moderation in the travel account. On the financial account, gross inflows of foreign direct investment are anticipated to continue to moderate in 2009, as multinational corporations postpone their investment plans until clearer signs of a recovery in demand emerged.

The projected economic performance of -1% to 1% for Malaysia in 2009 is based on the weaker global conditions expected during the year, that will be partially offset by the implementation of policy measures to support domestic demand. The timely implementation of the economic stimulus is, therefore, critical in ensuring that the outcome will be at the higher end of the projected range. There remains, however, significant uncertainties regarding the

Potential Output of the Malaysian Economy

Potential output is the level of output that is consistent with the aggregate productive capacity of the economy. It provides an indication of the sustainable pace of economic growth, given the available productive inputs. The growth in potential output is determined by the expansion and non-inflationary utilisation of physical capital and labour, as well as growth of total factor productivity (TFP), which captures productivity gains from improvements in factor inputs as well as overall economic efficiency.

The latest estimate indicates that the potential output of the Malaysian economy was close to 5.1% in 2008, with the output gap[1] of positive 0.5% of potential output. The small positive output gap suggests that the Malaysian economy was performing close to its potential with minimal demand-driven inflationary pressure. Overall, since the year 2000, the Malaysian economy has been experiencing this trend of relatively balanced growth as shown by the output gap, which was on average less than ±1% of potential output.

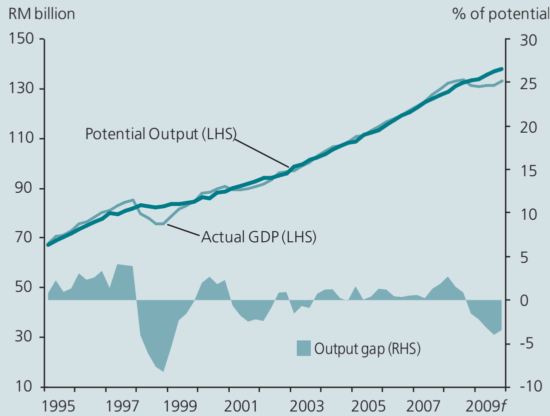
Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	Annual change (%)				(% of potential output)
1993-1999	6.5	6.6	4.3	3.2	0.0
2000	8.9	4.0	26.0	4.3	2.2
2001	0.5	4.6	-2.1	1.6	-1.8
2002	5.3	3.9	0.6	3.5	-0.4
2003	5.8	6.0	2.8	3.6	-0.6
2004	6.8	5.5	3.6	4.0	0.6
2005	5.3	5.1	5.0	4.1	0.8
2006	5.8	6.0	7.9	2.2	0.6
2007	6.3	6.0	9.6	2.0	0.9
2008e	4.6	5.1	1.1	1.2	0.5

e Estimate

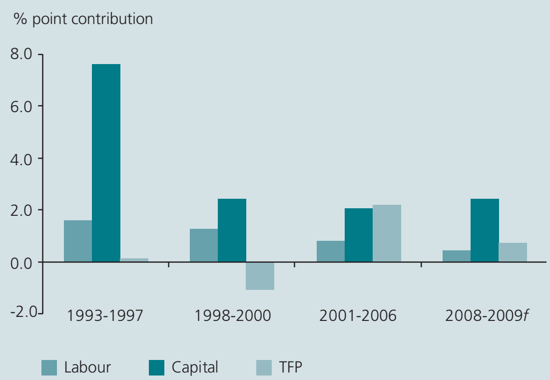
As a small open economy, Malaysia is being affected by the severe global financial and economic crisis. Under this environment, potential output is therefore projected to moderate in 2009 due to an expected decline in overall productivity (TFP) and labour force participation as well as stagnation in capital stock growth, consistent with the experience during previous periods of slowdown. However, the output gap is projected to be negative in 2009 given the larger expected moderation of actual output.

Chart 1
Actual and Potential GDP



f Forecast

Chart 2
Factor contributions and TFP growth



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[1] The output gap is the difference between the levels of actual and potential output and the gap is measured as a percentage of potential output. A positive output gap indicates that actual output is above potential output, while a negative output gap indicates the reverse.

global economic outlook. First, the turmoil in the international financial markets may be more protracted and extend beyond this year, with problems in the financial sectors in a number of countries remaining unresolved, thereby further exerting downward contractionary influence on the global economy. Second, the large stimulus measures that are being implemented by several countries would take some time to take effect. Thirdly, there is the risk of trade and financial protectionism. These factors will influence the depth and length of the recession in the advanced economies and the overall direction of the global economy. Nevertheless, the strengths of the Malaysian economy, in terms of a strong banking sector, a healthy external position, high savings as well as relatively low indebtedness among individuals, businesses and the Government, provide flexibility for the economy to better weather this challenging period and recover once the global economic and financial conditions stabilised.

Domestic Demand Conditions

Domestic demand is projected to experience a moderate growth of 2.9% in 2009, reflecting mainly the adverse spill over effects of the deepening global downturn on private sector activity. Household consumption is projected to moderate while capital spending by businesses is expected to contract further during the year.

Domestic demand to moderate in 2009 as a deeper global downturn affects household consumption and business spending. The public sector will be the main impetus of domestic demand

Nevertheless, domestic demand will be supported by higher Government spending. The public sector will be the main impetus of domestic demand, in particular following the implementation of two economic stimulus packages in 2009. With the prospect of inflation receding significantly, a substantial easing of monetary policy is aimed at supporting domestic economic activities. In addition, the domestic financial system has the capacity to continue to meet the financing needs of both households and businesses.

Table 4.1
Real GDP by Expenditure (2000=100)

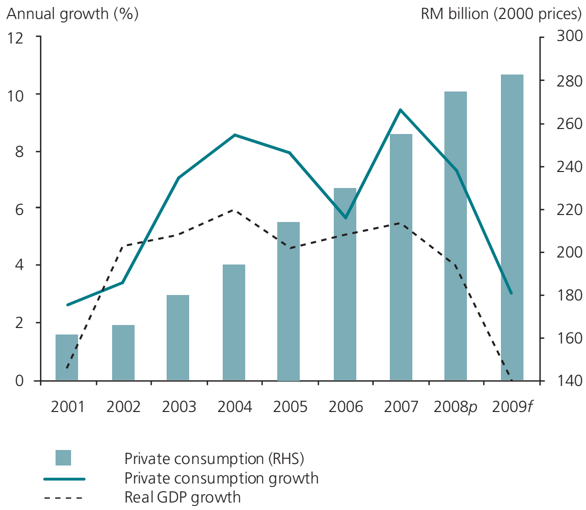
	2008*p*	2009*f*	2008*p*	2009*f*
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic Demand[1]	**6.9**	**2.9**	**6.0**	**2.6**
Private sector expenditure	7.1	-0.3	4.4	-0.2
Consumption	8.4	3.5	4.3	1.8
Investment	1.5	-17.7	0.2	-2.0
Public sector expenditure	6.5	11.4	1.6	2.8
Consumption	11.6	7.3	1.5	1.0
Investment	0.7	16.6	0.1	1.8
Change in stocks			**-0.8**	**1.4**
Net exports of goods and services	**-3.8**	**-29.7**	**-0.5**	**-4.0**
Exports	1.5	-16.6	1.8	-19.7
Imports	2.2	-14.9	2.4	-15.7
Real Gross Domestic Product (GDP)	**4.6**	**-1.0~1.0**	**4.6**	**-1.0~1.0**

Note: Figures may not necessarily add up due to rounding
[1] Excluding stocks
p Preliminary
f Forecast
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Growth in **private consumption** expenditure is expected to moderate but register a positive growth of 3.5% in 2009. The slower expansion in consumer spending will be affected largely by the weaker domestic labour market conditions with higher retrenchments and less favourable employment prospects. Labour demand in various sectors is envisaged to be weaker, with decline in the manufacturing sector being a major cause for the weaknesses. In view of this, the average increase in private sector salary is expected to moderate to 2.7% while the unemployment rate is projected to increase to 4.5% of the labour force. At the same time, affected companies have embarked on cost-cutting measures, including salary reductions, shorter work-week, unpaid leave and temporary layoffs. In addition, significant declines in commodity prices since the fourth quarter of 2008 have substantially affected incomes of smallholders.

While consumer confidence is affected by the weakening trend in employment and economic

Chart 4.3
Real GDP and Private Consumption



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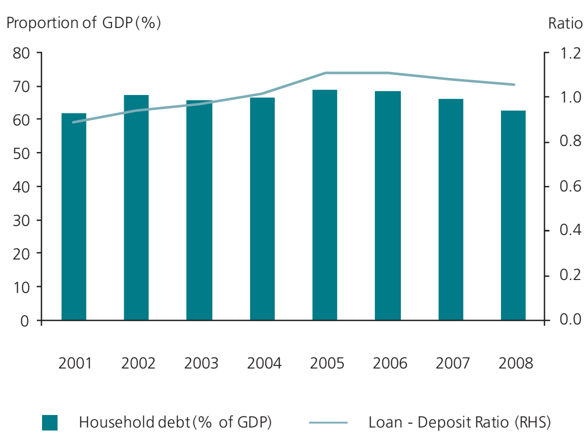
activity, policy responses, including the substantial easing of monetary policy and the continued access to credit, will provide some support to private consumption. In addition, several measures in the economic stimulus packages are expected to lessen the impact of the economic slowdown on the households. These include the reduction of EPF contributions from 11% to 8%, an increase in vehicle loan eligibility for civil servants, and several measures to increase employment and training

Chart 4.4
Household Debt Indicators



opportunities contained in the second economic stimulus package.

Private investment is projected to decline by 17.7% in 2009 as capital spending activities will be affected by falling demand and negative business sentiments due to the worsening global economic conditions. While this trend of declining private investment has taken place in the fourth quarter of 2008, the impact of the slower economic growth is expected to be more widespread, affecting most economic sectors in 2009. Investment activities in the manufacturing sector will experience the largest decline, as external demand contracts further and domestic demand moderates. Although a high level of total investment was approved in the manufacturing sector in 2008, firms are expected to postpone some investment plans until there are clearer signs of recovery in demand. Furthermore, capacity utilisation rates are expected to fall during the year, which will discourage further capacity expansion.

In the services sector, consumer-oriented business segments such as transportation and communications are expected to continue to undertake investments, mainly to improve the provision of services. Businesses in the wholesale and retail trade sub-sector are also expected to expand their operations, though more selectively and at strategically located new outlets. In the mining sector, capital spending will moderate and be channelled towards maintaining existing production facilities and exploration activities in view of long-term commitment to ensure sustainable reserves. In addition, capital expenditure in the construction sector will benefit from the implementation of projects identified in the stimulus packages as well as the Ninth Malaysia Plan (9MP).

Public consumption is expected to increase by 7.3% in 2009, due mainly to higher expenditures on emoluments and supplies and services. Of importance, the higher allocation for supplies and services is to ensure the effective delivery of Government services to support the private sector and cushion the impact of the external downturn on affected segments.

Public investment is expected to increase strongly in 2009, as the Government implements counter-cyclical measures to mitigate the impact of the externally-induced slowdown on the economy. Federal Government spending will be higher, mainly channelled towards improving the economic and social sectors of the economy. In addition to projects under the 9MP, the Government is expected to accelerate the implementation of various projects identified in the two stimulus packages. In the social services sector, a major part of the allocation will be utilised to improve the Government's provision of essential services such as education and health, the development of infrastructure in the rural areas and the building of affordable houses. Capital spending by the non-financial public enterprises (NFPEs) is expected to moderate due to slower economic activity. This will be reflected in the slower capacity expansion in the oil and gas as well as utilities sub-sectors. Investments by the NFPEs in the communications and utility sub-sectors will focus on enhancing broadband network and improving power supply respectively.

Sectoral Outlook

On the supply side, the year 2009 will be a challenging year for most sectors in the economy, particularly industries directly exposed to the external demand. The contraction in global demand is expected to continue to adversely affect the manufacturing sector as well as trade- and tourism-related industries in the services sector. In addition, the spillover of weaknesses in external demand and the generally cautious economic environment will lead to moderating private sector activities in domestic dependent sectors, in line with the slower pace of growth in domestic demand. Nonetheless, the domestic-oriented sectors will be partially supported by expansionary fiscal and accommodative monetary policies. In particular, the construction sector is expected to benefit from higher Government spending and register stronger growth in 2009.

The year 2009 will be challenging for most sectors in the economy, particularly industries directly exposed to the external demand

Amidst slower overall economic activity, growth in the **services** sector is expected to moderate to 4.5% in 2009. However, as the sector is more domestically driven, the slower but continued growth in domestic demand, together with supportive fiscal and monetary policies, will provide some support against the weaker performance of trade- and tourism-related activities that are expected to prevail in 2009. As a whole, the services sector will remain the key growth sector of the economy in 2009, contributing 2.5 percentage points to the overall GDP growth.

The **finance and insurance** sub-sector will continue to grow in 2009, albeit at a slower pace. In line with slower private sector activity, both lending activity and the insurance business are expected to moderate. Fee-based income is also expected to reflect the subdued activity in the capital markets. The lower demand for financing will, however, be partially offset by an accommodative monetary environment and new measures introduced by the Government and Bank Negara Malaysia to enhance access to financing for viable businesses, such as the RM2 billion SME Assistance Guarantee Scheme, the RM5 billion Working Capital Guarantee Scheme and the RM5 billion Industry Restructuring Loan Guarantee Scheme.

Table 4.2
Real GDP by Sector (2000=100)

	2008*p*	2009*f*
	Annual change (%)	
Agriculture	3.8	-2.0
Mining & quarrying	-0.8	-0.4
Manufacturing	1.3	-8.0
Construction	2.1	3.0
Services	7.3	4.5
Real Gross Domestic Product (GDP)	**4.6**	**-1.0~1.0**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Meanwhile, growth in the sub-sectors that are largely dependent on domestic consumption, such as wholesale and retail trade, and communications sub-sectors, will be sustained at a more moderate pace. The **wholesale and retail trade**, and **accommodation and restaurant** sub-sectors are projected to grow at lower rates compared to 2008. Growth in both sub-sectors will continue to be supported by domestic demand, amidst easing inflationary pressures. Nevertheless, the projected decline in new motor vehicle sales will have a negative impact on the automotive segment of the wholesale and retail trade sub-sector, despite some support from the Government's auto-scrapping scheme. Furthermore, consumers are expected to be cautious in their spending due to the uncertainty in the economic environment, while the expected decline in tourist arrivals will also have some impact on both sub-sectors. The **communication** sub-sector is expected to continue to register favourable growth in 2009, supported by sustained demand for mobile communication and broadband services. In particular, expansion of broadband coverage following further investment in the high speed broadband project and WiMax services will provide impetus for growth in the sub-sector.

Moderation in growth is expected to be more pronounced in trade- and business-related services due to the weakening external demand. Growth in the **transport and storage** sub-sector is expected to slow, as the anticipated lower trade and manufacturing activity will adversely affect demand for shipping and other cargo-related transportation services. Similarly, the passenger segment is expected to be affected by lower global demand for air travel. However, the impact will be cushioned by the extensive promotion of low air fares and the implementation of the ASEAN Open Skies Policy on 1 January 2009. Meanwhile, growth in the **utilities** sub-sector will be affected by the moderation in demand for electricity, particularly from the industrial sector.

The **manufacturing** sector is projected to decline sharply in 2009 (-8%; 2008: 1.3%), to be led by steep contractions in export-oriented industries and weaker support from domestic-oriented industries. In particular, the E&E industry is expected to be the worst affected by the sharp deterioration in global conditions affecting the final demand for all E&E products. Similarly, weak external demand and declining commodity prices will affect the performance of the primary commodities related industries. Nonetheless, demand for hygiene and medical rubber gloves will continue to provide support to the rubber industry. The consumer-related industry is expected to grow at a slower pace due to the expected decline in demand for motor vehicles which will affect the manufacturing of transport equipment. However, performance in this industry will be supported by sustained growth in the food and beverages industries given moderate but continued growth in domestic demand. Construction-related industries are expected to move in tandem with the broad construction sector and resume a more favourable growth path in the second half of the year as the economic stimulus measures take effect.

The **agriculture** sector is expected to register a decline of 2.0%, due mainly to lower production of both palm oil and rubber as the expected lower prices of both commodities will reduce the incentive for marginal producers to maintain the output growth trend seen in recent years. However, this decline will be partially mitigated by positive growth in the food crops sub-sector, particularly livestock, fisheries and vegetables.

The **mining** sector is projected to decline marginally by 0.4%, as the decline of 2.2% in crude oil output to 675,000 barrels per day will be offset to some extent by a 2.9% increase in natural gas output due to LNG demand from a new buyer, PR China, which is expected to commence in the second half of 2009.

The **construction** sector is expected to expand by 3% in 2009, supported by the civil engineering segment due to the implementation of projects under the two economic stimulus packages. Meanwhile the residential sub-sector is expected to moderate as weakening consumer sentiments lead developers to reduce launches of new housing developments, thereby keeping the overhang at manageable levels. Nevertheless, the measure to provide tax relief on interest paid for housing loans will provide some support to demand for houses.

Balance of Payments

On the external front, the deepening of the global economic downturn and persistent uncertainty in the international financial markets are expected to continue to impact trade and capital flows in 2009. In tandem with the significantly weaker external demand and lower commodity prices, gross exports are expected to decline substantially. Nevertheless, the trade surplus is projected to remain sizeable as export contraction would largely be offset by import compression. The weaker export and slower domestic economic activity are expected to significantly reduce imports of intermediate goods as well as imports of capital and consumption goods. Meanwhile, the services, income and current transfers accounts are expected to record deficits. Taking all these into consideration, **the current account surplus** is thus projected to moderate but remain sizeable at RM80 billion or 11.5% of GNI in 2009.

Meanwhile, capital flows will remain subdued reflecting the weaker external environment.

Gross exports are expected to decline sharply by 25.3% in 2009, as exports will be simultaneously affected by the manufacturing and commodity downturns. The contraction in manufactured exports is projected to be most pronounced in the E&E industry, due to the combined effects of declining global demand as well as falling prices. Meanwhile, the decline in the value of primary commodities and resource-based manufactured exports reflects largely the price effect, arising from the large corrections in commodity prices already seen in the second half of 2008, with prices expected to remain subdued in 2009. Agriculture exports are projected to decline due to lower prices and reduced demand for crude palm oil and rubber, while mineral exports will contract due to lower prices of crude oil and LNG.

With the weaker global economic outlook, export growth and capital flows are expected to be impacted further in 2009. Nevertheless, the current account surplus will remain sizeable as export contraction would be largely offset by import compression

In line with the weaker demand for manufactured exports and slower domestic economic activity, **gross imports** are expected to decline by 21.2%. Intermediate imports, which account for 70% of gross imports, are projected to decline as manufacturers reduce their production in line with the declining export orders. Imports of capital goods are also anticipated to decline sharply following the expected slowdown in the implementation of existing private sector investment projects and the postponement of new investment commitments. Meanwhile, imports of consumer goods are expected to decline marginally in line with more cautious consumer spending in the domestic economy.

The **services account** is projected to record a deficit of RM0.9 billion in 2009, as deficits in the transportation and other services accounts are expected to more than offset the surplus in the travel account. The travel surplus will moderate due to lower projected tourist arrivals as the weaker global economic outlook will affect travel by both corporates and households. With the anticipated further weakening of global trade and the travel industry, transportation earnings by domestic shipping and airline companies are expected to be lower. The deficit in other services account is expected to persist, reflecting continued payments, albeit lower, for imports of construction, communication and professional services.

The **income account** deficit is projected to be lower at 1.5% of GNI, reflecting mainly lower profits and dividends accruing to MNCs operating in Malaysia. The lower income projection is in line with the expected weaker export performance of the E&E industry as well as the oil and gas sector. Meanwhile, profits and dividends accruing to Malaysian companies investing abroad are also expected to be lower, particularly in the oil and gas, construction and services sectors.

Table 4.3
Balance of Payments

	2008*e*	2009*f*
	RM billion	
Goods	170.1	108.1
Trade account	141.9	84.9
Exports (% annual change)	*9.6*	*-25.3*
Imports (% annual change)	*3.3*	*-21.2*
Services	1.7	-0.9
Balance on goods and services	**171.8**	**107.2**
Income	-25.4	-10.6
Current transfers	-17.0	-16.6
Balance on current account	**129.4**	**80.0**
% of GNI	**18.1**	**11.5**
Capital account	0.6	
Financial account	-123.9	
Balance on capital and financial accounts	**-123.3**	
Errors and omissions	-24.3	
of which:		
Foreign exchange revaluation loss	*-5.8*	
Overall balance	**-18.2**	

Note: Numbers may not necessarily add up due to rounding
e Estimate
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 4.4
External Trade

	2008*p*		2009*f*	
	RM billion	Annual change (%)	RM billion	Annual change (%)
Gross exports *of which:*	**663.5**	**9.6**	**495.7**	**-25.3**
Manufactured	491.9	3.6	389.2	-20.9
Agriculture	68.1	30.0	35.7	-47.6
Minerals	87.5	43.2	54.7	-37.5
Gross imports *of which:*	**521.6**	**3.3**	**410.8**	**-21.2**
Capital goods	69.9	...	57.2	-18.2
Intermediate goods	379.1	5.7	286.5	-24.4
Consumption goods	32.3	11.8	31.4	-2.8
Trade balance	**141.9**	**41.4**	**84.9**	**-40.2**

... Negligible
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

On the **financial account**, gross inflows of **foreign direct investment** (FDI) are anticipated to decline in 2009. The moderation, which began in the second half-year of 2008, is expected to continue into 2009 as business confidence worldwide remains weak and MNCs operating in Malaysia become increasingly focused on capital preservation in an environment of very weak global demand. Foreign investment in the manufacturing sector, in particular the E&E industry which are funded mainly by retained earnings, are anticipated to decline as MNCs are expected to continue to repatriate a larger share of their income back to their parent companies. Despite the higher levels of foreign manufacturing projects approved in 2007 and 2008, the implementation of these projects will likely be affected by the curtailment and postponement of investment plans given the weaker global demand conditions. In addition, rising excess capacity amidst the falling demand is expected to further discourage investment activity in the manufacturing sector. Meanwhile, FDI in the oil and gas sector is also expected to moderate given the falling prices and demand for crude oil. FDI in the services sector is also expected to be lower due mainly to declining merger and acquisition activity by foreign investors in an environment of falling global FDI flows.

Similarly, **direct investment abroad by Malaysian companies** is anticipated to be lower in 2009, with investments channeled mainly into the regional and other emerging economies. During the year, outflows for acquisitions of strategic interests in the services sector, which were committed towards end-2008, are expected to continue, particularly in the utilities and transportation sub-sectors. Meanwhile, overseas investments in the oil and gas, and construction sectors are expected to moderate, following the projected subdued performance of the oil and gas sector as well as a slowdown in the implementation of infrastructure and development projects, particularly in the Middle East and South Asia.

Labour Market Outlook

The labour market is expected to further weaken in tandem with the slowdown in economic activity. Following the sharp deterioration in external demand since late 2008, businesses, particularly in those sectors that are exposed to external trade, are likely to continue to implement cost-cutting initiatives, including shorter work-week, voluntary separation schemes, temporary layoffs and retrenchments. The cautious sentiment amongst employers is indicated in the 2008-2009 Survey by Bank Negara Malaysia on employment outlook in the manufacturing, services and construction sectors, where about 24% of companies stated that they would reduce the number of jobs in 2009.

Weaker labour market conditions in 2009

In contrast, the public sector is expected to step up its employment drive with the aim of employing 63,000 people in 2009-2010. In addition, the Government has also unveiled several measures to provide training opportunities to Malaysians affected by the economic slowdown as well as to incentivise employers to recruit retrenched workers. It is expected that 100,000 training opportunities will be created through these

Table 4.5
BNM Survey on Salary Outlook in 2009

	2008*e*	2009*f*
Average - all sectors	**5.9**	**2.7**
Construction	6.3	3.1
Services	5.1	2.7
Manufacturing	6.3	2.2

e Estimate
f Forecast
Source: BNM Survey, 2008/2009

initiatives. Nonetheless, these measures would not be able to fully offset the overall weak prospects in the labour market. Consequently, the **unemployment rate** is expected to increase from 3.7% in 2008 to 4.5% in 2009, while the average private sector **salary** increase is expected to moderate to 2.7% (2008: 5.9%).

Inflation Outlook

Headline inflation is expected to slow significantly to average between 1.5% and 2.0% in 2009. This reflects the continued moderation in global energy and food prices and slowing global inflation precipitated in part by the reversal in commodity prices caused by the global financial deleveraging and the contraction in global economic activity. As a small and highly open economy, the decline in global commodity prices and recessionary influences will have a material impact on price developments in Malaysia. Domestically, the impact of downward adjustments to administered prices by the Government and the expected slowdown of economic activity will also restrain price pressures.

Global commodity prices are expected to continue to fall in 2009 in line with the slowdown in global economic activity. Crude oil prices as reflected in the West Texas Intermediate futures front-month have averaged USD40.59 per barrel in January-February 2009, representing a 72.1% decline since the peak in July 2008 and a 59.2% decline from the average of 2008. The sharp increase in world cereal production (comprising wheat, rice and coarse grains) in 2008 will facilitate a rebalancing of the global cereal supply and demand in 2009. Data from the February 2009 edition of the Food and Agriculture Organization of the United Nations' (FAO) *Crop Prospects and Food Situation* indicates that the ratio of cereal production relative to utilization has increased from 0.97 in 2006/07, to 1 in 2007/08, and to 1.03 in 2008/09. This development has exerted downward pressure on international cereal prices.

The prevailing global economic and financial crisis has significantly weakened the outlook for demand across both developed and emerging economies. The weak demand conditions are likely to depress prices in the affected countries. Consequently, inflation in the countries that are Malaysia's major sources of imports is expected to nearly halve to 2.6% in 2009 from 5.1% in 2008. This will allow greater flexibility for local importers and users of imported inputs to align prices with domestic demand conditions.

Similarly, the weaker external environment has begun to affect domestic economic activity. Faltering export demand has adversely affected the manufacturing and resource-based sectors, as well as the service sector that is dependent on them. The general deterioration in consumer and investor sentiments is expected to culminate in a broader fall in demand. The expected rise in unemployment and the corresponding moderation in disposable incomes, as well as the larger output gap are likely to keep demand-driven price pressures contained.

The series of adjustments to administered prices by the Government will have a noticeable impact in reducing inflation. The lapse of the impact from the adjustments to retail fuel prices in 2008 is expected to exert a significant downward impact on inflation in the second half of 2009. The reduction of electricity tariffs and gas prices announced in February 2009 will further ease consumer price inflation both directly, and indirectly through lower costs of productive inputs. Any further reductions in administered prices during the year will have a similar effect on inflation. In the current challenging economic environment, the downward adjustments to prices by the Government will significantly help to alleviate the burden of households and businesses by keeping prices and production costs low.

In terms of the countervailing upward pressures on inflation, the depreciation of the ringgit's nominal effective exchange rate since the beginning of 2008 has been relatively small, and is unlikely to result in higher imported prices. There may also be a temporary loss of productivity as the economy adjusts to the lower demand. However, the impact of this on inflation is expected to be more than offset by the strong forces behind the moderation in economic activity as wage and input costs are reduced. Consequently, inflation will remain low in 2009, especially in the second-half of the year.

MONETARY POLICY IN 2009

The world economy will continue to face significant challenges in 2009. The advanced economies, representing more than 60% of the world economy, are expected to be in recession. Likewise, the export driven economies in Asia face the prospect of a severe slowdown in economic activity. As one of the most open economies in the region, Malaysia is already affected by the deteriorating external environment.

With the risk of inflation abating considerably, the balance of risk has shifted from inflation to growth. Headline inflation decelerated to 3.9% in January 2009 from the July 2008 peak of 8.5%. There are strong indications that this downward trend is likely to continue during 2009. The weakening global demand has brought down global food and energy prices and is expected to continue to exert downward pressure on domestic inflation. Wage demands will be muted. Conversely, the risk to economic growth has intensified. Manufacturing production and exports have declined since September 2008 and October 2008 respectively, particularly in the electronics and electrical sector. The deepening of the global economic downturn is likely to affect domestic economic activity and employment prospects as the year progresses.

As a pre-emptive measure, the Monetary Policy Committee reduced the OPR by 25 basis points in November 2008, followed by further reductions of 75 and 50 basis points in January and February 2009 respectively to provide a more supportive monetary environment for the domestic economy. Lower interest rates are expected to provide support for domestic demand through the availability of credit at lower costs and by increasing disposable income through lower debt servicing costs. Lower interest rates also increase the affordability of loans and reduce the cost of capital.

Given the downside risk to growth, it is important that the financial system continues to function effectively and that the flow of credit is not impeded. At the first instance, reductions in the OPR need to be translated into lower retail borrowing costs speedily. To this end, the reductions in the OPR were accompanied by reductions in the Statutory Reserve Requirement (SRR) and the floor on deposit rates. This move softens the narrowing of bank margins, and thereby promotes the downward adjustments of interest rates. The demand for loans must also be matched by supply. The capacity of banks to provide credit will depend on the quality and strength of their balance sheets. Prudent policies and the substantial progress in developing and strengthening the domestic financial system since the Asian Financial Crisis have contributed to its resilience. As a consequence, the banking institutions' capacity to perform the intermediation function remains strong.

The reduction in deposit rates does not detract from the longstanding emphasis on ensuring a positive real rate of return to savers. With inflation trending down, the real rate of return on 12-month deposits is expected to average approximately above 0.5% this year. The Bank also announced the issuance of the Merdeka Savings Bond amounting to RM2 billion on 28 January as an additional savings instrument for Malaysian citizens aged 56 and above. Meanwhile, the Government has also announced the issuance of syariah-compliant Savings Bonds amounting to RM5 billion for citizens above 21 years old. With a nominal return of 5% per annum, the real return on these bonds are expected to average above 3% in 2009.

Going forward, the Bank will continuously assess the appropriateness of the OPR and its monetary policy stance. As monetary policy works with a lag, the Bank has frontloaded the cumulative 150 basis points OPR reduction in view of the significant moderation in the prospects for growth and inflation. In the next few months, the Bank will continuously assess whether all these measures are having their intended effects in sustaining domestic credit expansion and economic activity.

The current environment is exceptional both in terms of its gravity and scope. It will require a concerted policy response at both the national and international level. Globally, while central banks are easing monetary policy, governments are undertaking fiscal stimulus on a scale that are creating large fiscal deficits unseen in recent years. Such complementarity of policies is necessary. Monetary policy, as a demand management tool, has limits on the magnitude of reflation it can achieve in the current environment. Fiscal policy has an important role in compensating for the fall in private demand through an increase in public spending. In addition to the stimulus package of RM7 billion announced in November 2008, the Malaysian Government has announced an additional stimulus package worth RM60 billion on 10 March 2009 to mitigate the adverse developments in the external sector. The collective impact of monetary and fiscal policies should limit the effect of the global economic downturn on domestic economic activity and provide a firm base for the economy to return to its medium-term growth path once global economic and financial conditions normalise.

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FISCAL POLICY IN 2009

The severity of the global economic downturn and uncertainties on the length of the downturn is likely to lead to a general weakness in domestic confidence. Both monetary and fiscal policies are needed to mitigate the impact on the domestic economy and support domestic demand. While monetary policy has significantly lowered interest rates and provided ample liquidity to support financing activity, an expansionary fiscal policy is needed to directly support economic growth by increasing public spending, compensating for the declines in the external and domestic demand. It would also stimulate private sector demand by providing incentives for private consumption and investment.

The Federal Government's 2009 Budget announced in August 2008 was initially formulated with the principal objective of further strengthening the nation's economic resilience in the face of the two-fold challenges of rising inflation and increased uncertainties. Of importance was the greater focus on measures to ensure that the well being of Malaysians especially those in the lower and middle income groups is protected in an environment of volatile prices. Towards this end, a broad range of measures were introduced, including an increase in the eligibility criteria for welfare assistance from a monthly income of RM400 to RM720, a one-month bonus for civil servants and a reduction of import duties for several consumer products. In addition, personal income tax rates were reduced from 28% to 27% for those in the top income tax bracket and from 13% to 12% for the RM35,000 - RM50,000 tax bracket. Government spending also continued to be focused on enhancing the efficiency of public transport, improving health care and education, and providing housing incentives for Malaysians.

As the financial crisis deepened and the global economic situation worsened in the fourth quarter of 2008, fiscal policy was then geared to undertake a counter-cyclical role. Towards this end, the Government announced a RM7 billion Economic Stabilisation Plan on 4 November 2008. The plan, financed by the savings from the lower fuel subsidies expenses, represents a combination of public spending to compensate for the fall in private sector demand and measures to reinvigorate private spending. Of the total RM7 billion, RM4.7 billion is allocated for small-scale construction and development projects including the building of low- and medium-cost houses. The rest is channeled for upgrades and maintenance of social infrastructure and public amenities such as roads in rural areas, schools, hospitals, police stations and army quarters. In order to boost private consumption, the Government announced several other measures including the option to reduce employee's contribution to the Employees Provident Fund

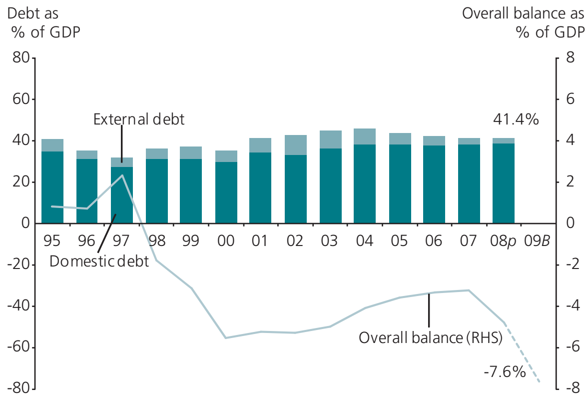
Table 4.6
Federal Government Finance

	RM billion		% change	
	2008*p*	2009*B*	2008*p*	2009*B*
Revenue	159.8	160.8	14.2	0.7
Total expenditure	196.3	215.9	20.0	10.0
Operating expenditure	*153.5*	*159.2*	*24.7*	*3.7*
Gross development expenditure	*42.8*	*56.7*	*5.6*	*32.4*
Loan recoveries	1.0	1.2		
Overall balance	**-35.6**	**-53.8**		
% of GDP	**-4.8**	**-7.6**		
Sources of financing:				
Net domestic borrowing	35.7	-		
Net external borrowing	-0.5	-		
Realisable assets [1] and adjustments	0.4	-		

[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets
p Preliminary
B Revised budget
Note: Numbers may not add up due to rounding

Source: Ministry of Finance

Chart 4.5
Federal Government Fiscal Balance and Debt



p Preliminary
B Revised budget

Source: Ministry of Finance

(EPF) from 11% to 8% for two years, extension of the repayment period for civil servants' housing loans and an increase in the limit for civil servants' car loans.

On 10 March 2009, the Government announced an additional stimulus package to mitigate the impact of a more pronounced global economic slowdown. The broad thrusts of the economic stimulus programme are to reduce unemployment and increase employment opportunities, assist and ease the burden of both households and businesses and build long-term capacity of the economy. The announced package amounting to RM60 billion or almost 9% of GDP, will be implemented over 2009 and 2010. Of the total, RM15 billion would be in the form of fiscal injection, RM25 billion for Guarantee Funds, RM10 billion for equity investments, RM7 billion for private finance initiative and RM3 billion in the form of tax incentives.

As a result of the large stimulus package, the Federal Government's fiscal deficit is estimated to widen from 4.8% of GDP in 2008 to 7.6% of GDP in 2009. The Government continues to finance the fiscal deficit from non-inflationary domestic sources, mainly through the issuances of Malaysian Government Securities (MGS) and Government Investment Issues (GII). In addition, the Government would issue a retail bond, the Government Savings Bond, amounting to RM5 billion. This, in part, provides an alternative savings instrument for savers. Importantly, with ample liquidity and high domestic savings in the domestic financial sector, public sector spending would not crowd out the availability of financial resources to the private sector.

Foreign Exchange Administration of Malaysia

While the protracted global financial crisis has yet to be resolved, many new lessons have been learnt. In this context, the implications for the pace of capital account liberalisation need to continuously be assessed. Malaysia has continuously reviewed the relevance of the remaining foreign exchange administration (FEA) rules to achieve greater efficiency in the conduct of international financial transactions. Issues for consideration is to ensure that there will be no disruption to the financing of international trade and investment in an environment of short US dollar liquidity, highly volatile capital flows, capital markets are more risk averse and heightened counterparty risks for settlement and payments.

During the height of the Asian financial crisis, the FEA rules assumed a significant role and were implemented as part of a comprehensive Economic Recovery Plan to expedite reforms, restore stability and promote growth in the domestic economy. With the stabilisation of the economy following the implementation of the Economic Recovery Plan, the rules have been removed in a series of sequenced and progressive liberalisation initiatives. The liberalisation has extended beyond removing these rules. This has been in line with the overall philosophy of creating a conducive business environment to facilitate private sector expansion and enhance overall competitiveness of the economy. The country's improved economic fundamentals, a strong and resilient domestic financial sector as well as the development of a more effective and comprehensive surveillance framework have permitted a more rapid pace of liberalisation of the FEA rules since 2003. Major and significant liberalisations were made in 2005 and 2007 on rules affecting the flexibility of capital flows to enhance business efficiency and promote foreign direct investments.

In 2008, the FEA rules were further liberalised, aimed at enhancing Malaysia's competitiveness by facilitating greater flexibility and accessibility to financing by businesses and reducing the cost of doing business in Malaysia. A resident corporation is free to borrow any amount of foreign currency from licensed onshore banks, non-resident non-bank parent company and other resident companies within the same corporate group in Malaysia. The resident corporation is also free to refinance any outstanding approved foreign currency borrowing.

To provide additional flexibility of financing for real sector activities in Malaysia, a resident corporation is free to borrow any amount of ringgit from its non-resident non-bank parent company for such purposes. A non-resident non-bank company or individual is also allowed to borrow any amount in ringgit from resident corporations as well as the licensed onshore banks to finance the real sector activities in Malaysia.

To promote Malaysia as an International Islamic Financial Hub, International Islamic Banks, International Takaful Operators and International Currency Business Units of licensed onshore banks, takaful operators or retakaful operators may make payments in foreign currency to resident intermediaries for the settlement of financial services rendered. In addition, to support the development of domestic financial markets, residents are free to invest in US dollar denominated crude palm oil futures contracts on Bursa Malaysia.

The remaining existing FEA rules are mainly for prudential safeguards to support monetary and financial stability and can be categorised as supporting the following broad objectives-

(i) Facilitating the effective use of domestic financial resources;
(ii) Sustaining manageable level of external debt;
(iii) Safeguarding against speculation on the domestic currency; and
(iv) Facilitating overseas investments by Malaysian corporations.

The deterioration of the global financial landscape in 2008 has underscored the need for prudent and pragmatic external debt management policies that are consistent with the country's long-term economic growth, extension of the domestic economic frontier and the nation's strategic economic agenda. In safeguarding against speculation on the ringgit, the non-internationalisation of the ringgit restricts the access to financing speculative activity on the ringgit by non-residents.

The administration of FEA rules – going forward

While the FEA rules are still relevant and would continue to serve as a prudential safeguard in supporting and complementing the broad macro-economic policy framework to maintain the country's economic and financial stability against external shocks, Malaysia remains committed to progressively liberalise the FEA rules. This is particularly important as Malaysia is a small and open economy with its domestic financial system highly integrated with the international financial markets.

The liberalisations going forward, will be conducted within a holistic framework and will be undertaken in an orderly and progressive approach with careful and comprehensive assessment to ensure the following guiding principles are met:

(i) The benefits of the liberalisations outweigh the costs and risks
The country has a strong track record of policy pragmatism and maintains the objective of ensuring that policies liberalised will be able to meet its goal of sustaining and enhancing competitiveness during periods of high and sustained economic growth as well as able to withstand periods of vulnerabilities and shocks that confront the domestic economy. The liberalisations undertaken thus far have yielded economic benefits to the country outweighing the trade-offs of the increased risks that may be associated with the liberalisations.

(ii) The liberalisations be supported by "readiness" of the economic and financial system
Consideration for liberalisation of the FEA rules will be based on comprehensive evaluation of the domestic and global economic and financial conditions to ascertain the state of readiness of the economy. Important preconditions include sound macroeconomic fundamentals supported by a sufficiently robust regulatory framework. This would be achieved through continuous environmental scanning, the establishment of an effective and a comprehensive surveillance system for early detection of possible vulnerabilities and emerging risks.

Conclusion

The country's strong trade and financial inter-linkages with the regional and global economies merit continuous review of the rules in order to continue to be supportive in facilitating the nation's economic transformation taking into account the new regional and global challenges. Malaysia will also continue to pursue a comprehensive strategy in administering the FEA rules to harness the full potential of the Malaysian economy while promoting a sound and stable financial system as well as a resilient and competitive economy. This comprehensive approach is key in the efforts towards achieving balanced and sustainable growth with stability.